Canadian Market
Infrastructure Committee

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Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Nova Scotia Securities Commission
Nunavut Securities Office
Ontario Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island

September 12, 2018

Dear Sirs/Mesdames:

Re: Proposed National Instrument 93-101 *Derivatives: Business Conduct* Published June 14, 2018 ("NI 93-101") and Related Proposed Companion Policy (the "Companion Policy", and together with NI 93-101, the "Proposed Rules")

INTRODUCTION

The Canadian Market Infrastructure Committee ("**CMIC**") is pleased to provide this comment letter on the Proposed Rules.

CMIC was established in response to a request from Canadian public authorities,[1] to represent the consolidated views of certain Canadian market participants on proposed regulatory and legislative changes in relation to over-the-counter ("**OTC**") derivatives. CMIC brings a unique voice to the dialogue regarding the appropriate framework for regulating the Canadian OTC derivatives market. The membership of CMIC has been intentionally designed to present the views of both the 'buy' side and the 'sell' side of the Canadian OTC derivatives market, including, but not limited to, both domestic and foreign owned banks operating in Canada as well as major Canadian institutional market participants (including a number of major pension funds) in the Canadian derivatives market. This letter reflects the consensus of views within CMIC's membership about the proper Canadian regulatory and legislative regime applicable to the OTC derivatives market.

Since 2010, CMIC has been providing commentary on proposed draft rules and consultation papers with respect to the regulation of the OTC derivatives market in Canada. CMIC's comment letters have consistently supported the harmonization of rules across Canada. Since the OTC derivatives

[1] "Canadian public authorities" means representatives from Bank of Canada, Canadian Securities Administrators, Department of Finance and The Office of the Superintendent of Financial Institutions.

market is a global market[2] with Canada representing only approximately 4% of that global market,[3] it is very important that our OTC derivatives rules are harmonized across Canada and also harmonized with regimes in larger markets outside Canada. It will otherwise become too costly for a foreign counterparty to enter into OTC derivatives transactions with a Canadian counterparty if it requires analysis and compliance with rules that are different across provinces and territories and inconsistent with global rules.

BACKGROUND – PREVIOUS RESPONSE LETTER

CMIC provided a detailed comment letter dated August 31, 2017 (our "**Initial Response**")[4] on the draft proposed National Instrument 93-101 published on April 4, 2017 (the "**Initial Draft of NI 93-101**"). CMIC members are very concerned that virtually none of its recommendations, and certainly none of its significant recommendations, in its Initial Response were accepted by the Canadian Securities Administrators ("**CSA**"). The second draft of NI 93-101 fails to take account of the very serious issues raised by CMIC and other commentators in the first round of public consultation. If implemented, this rule, particularly in combination with the draft registration rule published April 19, 2018 (the "**Registration Rule**" or "**NI 93-102**"),[5] would cause harm to the Canadian economy because the rules would significantly reduce liquidity in the Canadian OTC derivatives market both cross-border and domestically. These two draft rules fail to (i) present a Canadian regime that is harmonized with global regulatory initiatives and international standards, taking into account the smaller market size in Canada, (ii) recognize the difference between "securities" and "derivatives" markets; (iii) calibrate derivatives rules (as per IOSCO recommendations[6]) where equivalent prudential regulation is present; and (iv) recognize their disruptive impact on a well-functioning and well-regulated market. Furthermore, these failings are present notwithstanding that no justification for introducing a unique unharmonized Canadian regime is provided. In this letter, we will be referring to certain submissions made in our Initial Response which were not accepted, but on which we have further commentary and support.

EXECUTIVE SUMMARY

Our submissions in this letter are supported by these six principal themes:

1. <u>Derivatives Market Liquidity</u>: Ensuring that Canadian OTC derivatives market regulation does not significantly reduce liquidity is a critical objective. The broad extraterritorial effect of the Proposed Rules place Canadian counterparties at a significant disadvantage. Regulation that imposes unique requirements will deter market makers from continuing to participate in the Canadian OTC derivatives market. This deterrent effect will be felt by both foreign banks and domestic banks, especially in those Canadian jurisdictions where they currently have a modest presence. Maintaining a robust, competitive Canadian OTC derivatives market is important for systemic and economic purposes. A properly functioning modern economy requires businesses to be able to hedge risks to their businesses.

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[2] In other words, a large majority of transactions entered into by Canadian market participants will be with a non-Canadian counterparty.

[3] Total notional amount of global OTC derivatives contracts at the end of June 2016 was USD 544 trillion. See "Statistical release OTC derivatives statistics at end-June 2016", Bank for International Settlements, November 2016 at pg. 11, available here, converted to CAD 701.76 trillion using the June 30, 2016 exchange rate of 1.29 found here. The Canadian OTC derivatives market is estimated at CAD 30 trillion for Q2 2016. See "Toward More Resilient Markets: Over-the-Counter Derivatives Reform in Canada", Bank of Canada Financial System Review, December 2016 at page 54, available here.

[4] Available here.

[5] See our letter on NI 93-101 dated September 12, 2018, submitted concurrently with this letter.

[6] International Organization of Securities Commissions ("**IOSCO**"), "International Standards for Derivatives Market Intermediary Regulation, Final Report", June 2012, available here ("**DMI Report**").

2. Incomplete Rules: It is impossible to properly analyze the Proposed Rules without completed appendices. Without completed appendices, the impact of the Proposed Rules cannot be understood. CMIC urges the CSA to conduct a third consultation on the Proposed Rules in its entirety once the appendices have been populated.

3. Balanced Derivatives Market Regulation: Proper derivatives market regulation must balance the costs and benefits of regulation, with the balance tipping in favour of further regulation only when there is an apparent problem that is not otherwise addressed by existing regulation. No such cost-benefit analysis has been conducted or problem identified. IOSCO has expressly recommended that regulation should not be adopted where prudential (or other) regulation already addresses any identified risk. Since Canadian prudential regulation covers these risks, further regulation is not necessary. Such an approach would be consistent with IOSCO recommendations.

4. OTC Derivatives Market vs Securities Market: There are fundamental differences between the securities market and the OTC derivatives market that are ignored by the Proposed Rules. We recommend that certain rules be amended or deleted in order to reflect these fundamental differences.

5. Harmonization: The Canadian OTC derivatives market is a part of a global market that relies heavily on global participation. Due to the relatively small size of the Canadian OTC derivatives market, many foreign dealers and advisers will not assume increased legal and regulatory risk and compliance burden associated with unique Canadian rules, which will result in a significant reduction in liquidity. Accordingly, we recommend that NI 93-101 be harmonized with global approaches and international standards, taking into account the smaller market size in Canada, particularly with the Commodity Futures Trading Commission's ("**CFTC**") rules[7] under Dodd-Frank[8] and certain portions of the definition thereunder of the term, "eligible contract participant".

6. Timing of Implementation: Given the proposed review and re-assessment of the CFTC rules and the fact that the Securities and Exchange Commission's ("**SEC**") business conduct rules are not in force, we recommend delaying the implementation date of the Proposed Rules to better ensure harmonization.

Here is a brief summary of our recommendations:

- Substituted Compliance: We recommend that, on an outcomes basis, foreign derivatives dealers that are registered as swap dealers under CFTC rules, investment firms that are subject to the requirements of MiFID II and Canadian financial institutions that are subject to OSFI supervision should be exempt from all the requirements under NI 93-101. If the CSA does not accept this recommendation, substituted compliance should be applicable for almost all of the provisions of NI 93-101, including the senior manager provisions, as outlined in detail in Schedule A and Schedule B of our Initial Response.

- Inter-dealer Exclusion: We strongly recommend and reiterate that the inter-dealer market be excluded from the Proposed Rules.

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[7] The CFTC's business conduct rules are principally located in the *Code of Federal Regulations*, Title 17, Chapter I, Part 23 ("**17 CFR Part 23**"), available at: https://www.ecfr.gov/cgi-bin/text-idx?SID=dbb5c5a633932a41e806929529662e54&mc=true&node=pt17.1.23&rgn=div5.

[8] *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub.L. 111-203, H.R. 4173 ("**Dodd-Frank**"), available at: http://www.cftc.gov/idc/groups/public/@swaps/documents/file/hr4173_enrolledbill.pdf.

- FX Transactions: Due to the maturity and transparency of the foreign exchange market, we recommend an exemption whenever a derivatives firm adheres to a global foreign exchange code of conduct and transacts in foreign exchange transactions.

- Eligible Derivatives Party: We recommend that the definition of "eligible derivatives party" be revised to:

  - remove the financial threshold for commercial hedgers in paragraph (n);
  - lower the financial threshold in paragraph (m) for a non-individual from net assets of $25 million to total assets of $10 million; and
  - remove the knowledge and experience requirement under paragraphs (m), (n) and (o).

- Exemption for Unknown Counterparties: We recommend that the exemption in Section 41 of NI 93-101 should not be conditional on the derivatives party being an EDP and the exemption should be expanded to (i) cover all trades with unknown counterparties (whether or not cleared), (ii) apply in respect of section 9 (Conflicts of interest), section 11 (Derivatives-party-specific needs and objectives), section 12 (Suitability), section 18 (Relationship disclosure information) and section 19 (Pre-transaction disclosure).

This letter will begin by setting out several general comments that elaborate on the six principal themes above. This is followed by our additional comments on other provisions of NI 93-101. Our responses to specific questions raised by the regulators in the Notice accompanying NI 93-101 are set out in Schedule A to this letter.

GENERAL COMMENTS

Derivatives Market Liquidity: As the CSA will have seen from the trade reporting data, the Canadian derivatives market is only a very small part of the global derivatives market, and more than 80% of the Canadian market involves foreign banks. These characteristics mean that preserving foreign liquidity is essential for Canadian businesses to be able to hedge the risks associated with their operations. Introducing unique regulatory requirements will significantly reduce liquidity because the added regulatory burden will dissuade foreign banks from maintaining existing Canadian operations or existing Canadian coverage across Canada. One key reason why the Proposed Rules, in their current form, will significantly reduce liquidity is their extraterritorial scope. As discussed in more detail on page 8 (Extraterritorial Scope), having the Proposed Rules apply to transactions entered into between two counterparties who are trading from non-Canadian locations will place Canadian counterparties at a significant disadvantage. If a foreign dealer located in, for example, Europe, is required to comply with Canadian business conduct rules when facing the UK branch of a Canadian bank, it will choose instead to trade with a non-Canadian counterparty. While CMIC recognizes that, as eligible derivatives parties, trades between dealers will be subject to a reduced set of business conduct obligations, foreign dealers will nevertheless have to be comfortable that their business conduct towards Canadian dealers comply with fair dealing and conflict of interest requirements. To do so, foreign dealers would have to retain Canadian legal counsel and accept the attendant legal and regulatory compliance risks. Additionally, such foreign dealers will also be required to implement the Canadian senior derivatives manager regime which contains a number of serious problems, such as reporting to boards of directors. Imposing a customized corporate governance structure on foreign dealers in order to trade with Canadian dealers is not tenable.

As discussed below, in its Initial Response Letter, CMIC proposed the granting of an Inter-dealer Exclusion to ensure that the Canadian OTC derivatives market remains liquid. The CSA rejected this approach indicating that, "It is inappropriate and inconsistent with the rule to provide an outright exemption for the inter-dealer market and also inconsistent with the approach taken internationally".[9] CMIC notes that, based on one of its member's inquiries to external Asia-Pacific counsel, it is our understanding that:

- In Hong Kong and Singapore, there are no business conduct rules specifically for OTC derivatives for the inter-dealer market that are similar to the business conduct rules under the Dodd-Frank regime. Know your client, disclosure and suitability obligations will apply in respect of OTC derivatives in the future, but counsel advises that the inter-dealer market will be exempt.

- In Australia, which has a market that is comparable in size to the Canadian OTC derivatives market, there are no business conduct rules specifically for OTC derivatives for the inter-dealer market that are similar to the Dodd-Frank regime, nor is counsel aware of any plans to create such rules. There are some business conduct obligations in the Australian Corporations Act 2001 which apply generally to the provision of financial services, with some obligations limited to retail clients. Licensees also have general obligations relating to honest conduct. These appear to be more principles-based, in line with OSFI guidance.

Therefore, there are precedents in other comparable jurisdictions for an Inter-dealer Exclusion with respect to the business conduct rule.

Finally, materially reducing liquidity will create material systemic risk and have economic consequences that are harmful and unnecessary. The proposed business conduct rule, especially when combined with the proposed registration rule, risks serious and dangerous curtailment in domestic and cross-border liquidity and access in the Canadian derivatives market.

Incomplete Appendices: Without knowing how the appendices will be completed, it is impossible to properly analyze the Proposed Rules. Foreign dealers, foreign advisers, Canadian financial institutions and IIROC dealer members do not know whether they will be exempt from any of the requirements under the Proposed Rules. Accordingly, certain comments provided will become more or less important to a market participant, depending on how the appendices are completed. Completing the appendices to the Proposed Rules will constitute a material change to the rule and accordingly the entire rule will then need to be re-published for another 60 day comment period[10] so that market participants can properly analyze the effects of the proposed derivatives business conduct regime.

Balanced Derivatives Market Regulation: It is essential that derivatives regulation be balanced. Introducing unique Canadian derivatives regulation should only occur where existing regulation fails to address an apparent problem. Duplicative regulation is unnecessary regulation. IOSCO recommendations[11] clearly recognize the need to take account of existing and efficiently operating prudential regulation in formulating the scope and content of derivatives regulation. A good example of such a balanced approach is seen in the extensive substituted compliance provided by the CFTC to Canadian banks with respect to various central features of Dodd-Frank on the explicit basis of federal Canadian prudential regulation and guidance. The proposed business conduct rule, especially when combined with the proposed registration rule, fails to meet this test of balanced

[9] See page 4825 of NI 93-101.
[10] See, for example, *Rule Making Procedure Regulation*, BC Reg 195/97. Available here.
[11] DMI Report, *supra* note 6.

regulation by not identifying material gaps in existing regulation and by not taking into account well-functioning existing prudential (or other) regulation.

<u>OTC Derivatives Market vs Securities Market</u>: As we noted in our Initial Response, some of the provisions in NI 93-101 do not take into account the fundamental differences between the OTC derivatives market and the securities market.

An OTC derivatives transaction is a bilateral, privately negotiated transaction where two parties are acting as principal and, generally speaking, both parties create credit exposure to each other during the term of the transaction which compels good practices. The provision and management of credit is a core function and mandate of banks exercising their responsibility to promote economic growth. By extension, OTC derivatives are core to the business of banking. As such, the infrastructure and control framework governing OTC derivatives is extremely robust and proven, and there is unique statutory treatment given to OTC derivatives as “eligible financial contracts” under insolvency law. The participants in this market are institutional and the business is not retail oriented.

Contrast the above with a securities transaction where one party offers an investment to a potential investor, the sale of which is effected by an intermediary that acts as both a principal and an agent. The investor in a securities transaction does not have any further obligations to the issuer of the security. There is a high degree of individual and retail client participation in the securities markets. There is perceived to be an informational imbalance between issuers and investors, which raises the need for protection of the investor by requiring prospectus-level disclosure in public offerings and certain disclosure in private offerings. In the OTC derivatives market, transactions are primarily used by individuals and corporations to hedge risks and, accordingly, they are not primarily investment products but risk management products that have substantially different financial profiles, i.e. loss of principal vs. mark-to-market exposure. In addition, in most cases, the perceived informational imbalance that exists in the securities markets is not present in the OTC derivatives market. As a result of these fundamental differences between the two markets, several concepts in the Proposed Rules which were derived from NI 31-103 are not applicable and are inappropriate to include in the Proposed Rules. For example, as discussed in greater detail below on pages 17 and 22, two of such provisions are the Fair Terms and Pricing and the Tied Selling provisions, respectively.

CMIC strongly recommends and reiterates that a three-tier structure is more appropriate than a two-tier structure and accordingly, all business conduct rules should not apply whenever dealers are transacting with each other. Please see our discussion below under Inter-Dealer Exclusion on page 10. This three-tier structure should be a significant step towards the recognition of the differences that exist between the OTC derivatives market and the securities market.

<u>Harmonization</u>: Another fundamental difference between the OTC derivatives market and the securities market is that the OTC derivatives market is global in nature. As mentioned above, more than 60% of OTC derivatives transactions that are entered into by Canadian bank members of CMIC involve non-Canadian counterparties. In addition, the Canadian OTC derivatives market represents a very small percentage of the global OTC derivatives market, based on notional amount. Therefore, the Canadian OTC derivatives market is very dependent on global participants. This highlights the importance of having Canadian rules harmonized as much as possible with global rules, taking into account the smaller market size in Canada. Adding unique Canadian rules is the opposite of harmonization. It has been the experience of CMIC members that certain foreign market participants do not find that the benefit of changing and expanding their policies, procedures and systems in order to accommodate unique Canadian rules outweigh the costs thereof. Harmonization with global rules, and in particular with the CFTC business conduct rules, which market participants who are swap dealers have been complying with for a number of years, is extremely important in order to have a

level playing field among market participants regardless of jurisdiction. Any variation from the CFTC business conduct rules that is not calibrated to the smaller and more vulnerable Canadian OTC derivatives market will disproportionately increase implementation and compliance costs for global market participants. This is likely to result in global counterparties exiting the Canadian market, thereby materially reducing liquidity and access, and increasing systemic risk.

We note that the Proposed Rules could apply to a person or company that meets the definition of "derivatives adviser" or "derivatives dealer", regardless of whether it is registered or exempted or excluded from the requirement to be registered in a jurisdiction. This approach is unharmonized with CFTC rules as well as rules in comparable jurisdictions, such as Australia. Moreover, this approach is unharmonized with domestic securities laws. Having the Proposed Rules apply to a person or company regardless of whether that person is required to be registered will only create market uncertainty and confusion. Further this approach could result in two different principal regulators, only adding to the confusion. In order to be harmonized both globally and domestically, the Proposed Rules should only apply to a person or company that is required to be registered under the Registration Rule as a "derivatives dealer" or a "derivatives adviser".

Timing of Implementation: As we noted in our Initial Response, NI 93-101 should not become effective until the CFTC has assessed and acted on public comments received in connection with its project to simplify and modernize its rules, including its business conduct rules, and making them less costly to comply with. It is imperative that the final version of NI 93-101 does not go beyond what is required under the revised CFTC business conduct rule once these CFTC recommendations have been adopted. For example, on August 21, 2018 the CFTC announced that it had simplified and alleviated certain chief compliance officer obligations and annual compliance reporting requirements for futures commission merchants, swap dealers and major swap participants.[12] In addition, CFTC Chairman Giancarlo has acknowledged that the CFTC's current approach to applying its swap rules to cross-border activities has resulted in a number of problems, causing fragmentation of global markets.[13] The relatively smaller and more vulnerable Canadian OTC derivatives market cannot withstand that kind of fragmentation and therefore the CSA should wait to see what the new CFTC approach will be. Further, the SEC's business conduct rules for securities based swaps are not yet in force. As NI 93-101 will also govern securities-based swaps, the Canadian regime would have imposed business conduct rules with respect to certain counterparties who only transact in securities-based swaps, but such counterparties would not be subject to such business conduct rules if dealing with US counterparties. Harmonization of NI 93-101 to US rules, taking into account the smaller market size in Canada, is critically important, and we recommend delaying the implementation of NI 93-101 until the later of the date on which the complete revised CFTC business conduct rules are in force and the date on which the SEC`s business conduct rules are in force.

SUBSTITUTED COMPLIANCE

As mentioned in our Initial Response, if the CSA used an outcomes-based approach in determining substituted compliance taking into account the entirety of the CFTC and MiFID II rules, as well as OSFI Guideline B-7 and other OSFI prudential rules, foreign derivatives dealers that are registered as swap dealers under CFTC rules, investment firms that are subject to the requirements of MiFID II and Canadian financial institutions that are subject to OSFI supervision would be exempt from all the requirements under NI 93-101.

CMIC notes that the IOSCO DMI Report recognizes that, for some jurisdictions, banks fall under the primary authority of prudential regulators and that "[t]he form the [licensing] requirements take is less

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[12] Commodities Futures Trading Commission, "Chief Compliance Officer Duties and Annual Report Requirements for Futures Commission Merchants, Swap Dealers and Major Swap Participants", 83 FR 43510. Available here.

[13] See CFTC Chairman Giancarlo's September 4, 2018 speech to the City of London. Available here.

important than the outcome of them."[14] Further, substituted compliance extended to Canadian banks by the CFTC[15] recognizes the absence of the need to address the requirements set out in the IOSCO DMI Report because of the presence of prudential regulation by OSFI through extensive and effective regulations and guidance. Accordingly, IOSCO's recommendations recognize that appropriate prudential regulation in a particular jurisdiction can easily provide sufficient regulatory coverage. Existing OSFI regulations and guidance are effective and supply the basis to exempt Canadian financial institutions from the requirements under NI 93-101.

However, if the CSA does not accept this approach, we remind the CSA that we completed Appendix A of the Initial Draft of NI 93-101 for foreign derivatives dealers and Appendix C for Canadian federally regulated financial institutions ("**FRFIs**") showing which specific sections should be given substituted compliance.

Since Appendix A and Appendix C of NI 93-101 remain blank, CMIC reserves the right to provide further comment on the entirety of NI 93-101 once those appendices have been published for comment. It is CMIC's view that these appendices are an integral part of the rule and, accordingly, we would need to consider the completed appendices in conjunction with the remainder of the rule, including the companion policy.

Further, the exemption for foreign dealers under Section 38 should not be conditional upon dealing with EDPs. If business conduct rules in a foreign jurisdiction are equivalent, it should not matter that the foreign dealer is not dealing with an EDP. Further, as discussed in greater detail in CMIC's response letter to the Registration Rule, imposing conditions on foreign dealers and advisers, such as complete and unfettered access to such foreign company's books and records is inappropriate and will materially and negatively affect liquidity in the Canadian OTC derivatives market. Substituted compliance without these types of conditions will encourage foreign dealers and advisers to maintain existing business in Canada, or enter the Canadian OTC derivatives market.

EXTRATERRITORIAL SCOPE

CMIC notes the clarifying commentary that has been added to the Companion Policy with respect to the determination of when a firm is a derivatives dealer or a derivatives adviser in a local jurisdiction. However, CMIC urges that further commentary should be added to clarify that a firm will be a derivatives dealer in a local jurisdiction only if its front office sales and trading personnel who are interacting with the counterparty are located in such local jurisdiction (or its counterparty is located in such local jurisdiction), and a non-dealer counterparty will be in a local jurisdiction if its head office or principal place of business is located in such local jurisdiction. To hold otherwise would significantly reduce liquidity for Canadian counterparties and place Canadian market participants at a significant disadvantage. We describe two scenarios below to demonstrate these two points.

With respect to how a broad application of the CSA's jurisdictional scope will significantly reduce liquidity for Canadian counterparties, if the Proposed Rules apply to foreign dealers when transacting with Canadian derivatives dealers who are acting from foreign locations, all things being equal, those foreign dealers will choose to trade with non-Canadian counterparties. Given the relatively small size of the Canadian OTC derivatives market, the costs and regulatory compliance burden of instituting new compliance procedures for the Proposed Rules will far outweigh any benefits or commercial opportunities of trading with Canadian counterparties. We note that even if the substituted compliance provisions under section 38 apply, this will not address this significant issue. In such circumstances, foreign dealers would still be subject to the requirements under section 38 of the

[14] Supra, Note 11 at 13.

[15] Comparability Determination for Canada: Certain Entity Level Requirements, 78 FR 78839, December 27, 2013, available here.

Proposed Rules which includes submitting to a Canadian jurisdiction, reporting to Canadian regulators "in a timely manner" circumstances of material non-compliance and providing Canadian regulators with unfettered access to its books and records for its global businesses, of which OTC derivatives may only be a portion (and certainly, OTC derivatives with Canadian counterparties would only be a very small fraction). Accordingly, expanding the CSA's jurisdiction in such a broad extraterritorial fashion will significantly reduce liquidity to Canadian market participants and be disruptive to the Canadian OTC derivatives market.

A broad assertion of the CSA's jurisdiction will place Canadian market participants at a significant disadvantage. Currently, Canadian banks transact OTC derivatives with private banking clients in foreign jurisdictions through foreign branches and are subject to, and comply with, local laws. For example, individual clients in Hong Kong and Singapore are subject to minimum thresholds of financial assets of SGD $2 million (roughly CAD 2 million) and HKD $8 million (roughly CAD 1.3 million). Local law also requires that clients have derivatives knowledge and that the bank perform suitability assessments by considering the client's risk profile, investment needs and relative product features. In addition, risk disclosures are provided to the clients. Local regulators are in the best position to determine the appropriate standards in the markets that they regulate. Based on information currently available to one CMIC Canadian bank member, it is estimated that approximately half of the individuals that trade with it through its private banking client division would likely not meet the proposed EDP threshold. However, that bank may not necessarily have information regarding financial assets that are not managed by it and therefore would need to perform a client outreach to determine whether clients are EDPs. As CMIC has noted in its Initial Response, obtaining responses from clients to an outreach request is very difficult, especially from non-Canadian clients as it relates to Canadian regulatory matters. In particular, it has been the experience of CMIC members that it has been especially problematic obtaining representations from private banking clients (indeed, any client) where other banks have not requested similar information. This will put Canadian banks at a competitive disadvantage in foreign markets, which is particularly concerning given the global nature of the OTC derivatives market. The Proposed Rules should not be applicable in circumstances where a derivatives dealer is transacting from a non-Canadian jurisdiction with a derivatives party located in a non-Canadian jurisdiction because, as it relates to the derivatives transaction or that derivatives party, there is no meaningful nexus to Canada. In such circumstances, the firm, and the individual acting on behalf of the firm, would need to comply with the local laws of the jurisdiction in which it and the derivatives party are located. There is no benefit to imposing Canadian rules, and the associated administrative burden of a client outreach, on derivatives parties in jurisdiction where local laws already provide sufficient protection. This approach has been endorsed by CFTC Chairman Giancarlo in his recent speech to the City of London. After acknowledging that the CFTC's current approach to applying its swap rules to cross-border activities has resulted in a number of problems, Chairman Giancarlo stated that swap reforms that address market structure and trading practices should be uniform within a single trading jurisdiction, not vary in any regulatory jurisdiction based on the nationality of the trading counterparty and should not create separate domestic and foreign trading liquidity pools within the same regulatory jurisdiction.[16]

As noted in our Initial Response, the Companion Policy should be amended to clarify that the activities of a person or company in one jurisdiction should not affect the characterization of its activities in another jurisdiction. For example, a US company registered as a US swap dealer is clearly in the business of dealing in derivatives in the US. However, if the only OTC derivatives transactions it enters into in Canada are with a Canadian bank for purposes of hedging its Canadian dollar exposure, such US swap dealer would <u>not</u> be a "derivatives dealer" in Canada. CMIC strongly recommends that this jurisdictional point be expressly clarified in the Companion Policy.

[16] Supra note 13.

Finally, if a foreign dealer is subject to the requirements under the Proposed Rules, the obligations under the rule should apply to its dealings with Canadian counterparties only, and not to the business conduct of the foreign dealer's entire organization and all its trading activities.

INTER-DEALER EXCLUSION

As we noted in our Initial Response, CMIC is of the view that the two-tiered approach does not go far enough and it therefore recommends that an exemption from the application of NI 93-101 be given to all derivatives dealers when transacting with another derivatives dealer or with a clearing agency[17] (such exemption, the "**Inter-dealer Exclusion**"). To be clear, there should be no conditions attached to this exclusion – as long as a transaction involves two derivatives dealers, the Proposed Rules should not apply.

The need for an Inter-dealer Exclusion is clear. Firstly, the main purpose of the Proposed Rules is to help protect investors. However, all bank members of CMIC unanimously agree that they do not need the protections under the Proposed Rules when transacting with other dealers. Secondly, CMIC notes that the CSA, in its notice and request for comment,[18] has quoted from the IOSCO DMI Report[19] as support for why these business conduct rules are necessary. However, the DMI Report is primarily focused on market intermediaries facing clients, and not facing other market intermediaries in particular and accordingly, the standards which IOSCO promotes should apply only when facing non-market intermediaries. Similarly, after years of considering this issue, U.S. regulators are focusing their best interest standards on retail customers and not institutional customers as set out in the S.E.C.'s proposed rule.[20] Thirdly, without this Inter-dealer Exclusion, CMIC is concerned that foreign dealers, particularly those whose home jurisdiction does not appear on Appendices A and D, would be subject to the business conduct rules and would therefore need to increase required resources and assume increased legal and regulatory risk and compliance burden to continue trading with other dealers. While CMIC recognizes that the business conduct obligations proposed for foreign derivatives dealers may, in practice, be more limited in scope than those proposed for local market participants, each foreign derivatives dealer that wishes to enter or stay in the Canadian market place will need to understand such obligations and accept the consequential legal and regulatory liability. CMIC members' prior experience suggests that many foreign dealers will not undertake the exercise in the first place and, in the end, simply choose to exit (or not enter) the Canadian market because of a unique Canadian regulatory burden. CMIC members have already experienced foreign dealers unwilling to trade with them because these foreign dealers were unwilling to understand what trade reporting obligations, if any, it had under Canadian trade reporting rules and because they were concerned about potential obligations under the Proposed Rules and the Registration Rule. Such foreign dealers have the option to trade OTC derivatives with other global dealers in larger jurisdictions such as Europe and the U.S. It would therefore make commercial sense to invest the additional resources and accept legal and regulatory risks in understanding business conduct rules in such larger jurisdictions, but unfortunately, given the size of the Canadian OTC derivatives market, that would not be the case for Canada.

CMIC further notes that substituted compliance for foreign dealers is insufficient to address the above concerns, unless substituted compliance has the effect of exempting the foreign dealer from all requirements under NI 93-101, including, for example, the delivery of a completed Form 93-102F1 *Submission to Jurisdiction and Appointment to Agent for Service*. This is why CMIC is proposing an exclusion under such circumstances in respect of all requirements of NI 93-101, as opposed to relying on substituted compliance.

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[17] See further discussion of clearing agencies on page 17 of this letter.
[18] See page 4804 of NI 93-101.
[19] DMI Report, *supra* note 6.
[20] Regulation Best Interest, 83 FR 21574, May 9, 2018, available here.

DIFFERENCES WITH FX MARKET

CMIC recommended in its Initial Response that any derivatives firm following the FX Code of Conduct[21] should be exempt from NI 93-101 in connection with any FX transaction, whether or not its counterparty is an EDP. CMIC made this recommendation based upon the fact that (i) the foreign exchange ("**FX**") market in particular should be treated differently than any other OTC derivative asset class given that the FX market is mature and transparent, (ii) the FX Code of Conduct is very comprehensive, setting out 55 principles in the areas of ethics, governance, execution, information sharing, risk management and compliance and confirmation and settlement, (iii) it has been adopted by the industry and received endorsement from the Bank of Canada[22] and (iv) any regulatory deviation from the FX Code of Conduct would result in market fragmentation.

This is one example of completely duplicative regulation. Given the recent universal application of the FX Code of Conduct to all FX transactions, there is no regulatory need for creating specific requirements with respect to FX products. The IOSCO DMI Report provides that: "Although there are a wide range of products that comprise the OTC derivatives market, and each product has different risks (such as systemic risk or risk of market abuse) jurisdictions should consider whether there is a regulatory need for creating specific registration requirements for each type of derivative product."[23] Accordingly, it is entirely appropriate, and in alignment with IOSCO standards, to have different standards apply to FX transactions.

The CSA has responded that the FX Code of Conduct does not impose legal or regulatory obligations on market participants. However, CMIC proposes that FX transactions would be excluded from the scope of NI 93-101 only if a derivatives dealer was in compliance with the FX Code of Conduct, thus imposing a regulatory obligation if a derivatives dealer were to rely on such exclusion, which is, in effect, no different than the framework around substituted compliance. In addition, if this exclusion were adopted, this would address the concerns we have with respect to the requirement for a written agreement in respect of FX transactions, as discussed on page 21 of this letter.

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[21] *FX Global Code*, available at: http://www.globalfxc.org/docs/fx_global.pdf ("**FX Code of Conduct**"). Over a two year period, FX market participants from 16 jurisdictions around the globe in partnership with 21 central banks representing the largest currency areas created this FX Code of Conduct, which is a single, global set of best practices principles that are right-sized for the FX market.

[22] The Governors of the Global Economy Meeting (of which the Governor of the Bank of Canada is a member) endorsed the FX Code of Conduct on 25 May 2017. See http://www.bis.org/press/p170525.htm. In addition, the Bank for International Settlements' Report on Adherence to the FX Global Code dated May 2017, tenet 3, required the role of central banks "To lead by example and demonstrate their commitment to promoting and maintaining good market practice. To facilitate this, "central banks will expect that their regular FX trading counterparties adhere to the principles of the FX Code of Conduct, except where this would inhibit the discharge of their legal duties or policy functions". See http://www.bis.org/mktc/fxwg/adherence_report.pdf, pg. 4. Further, at the Canadian Foreign Exchange Committee ("CFEC") Meeting (chaired by the Bank of Canada), it was noted that "The GFXC website (www.globalfxc.org), containing the FX Global Code, the FXWG Report on Adherence to the Global Code, the Statement of Commitment, the request for feedback on last look, the Terms of Reference and membership on the GFXC and other information, will be linked to the CFEC website. As previously discussed at CFEC, signing the Statement of Commitment will in future be a condition for membership of CFEC." See http://www.cfec.ca/files/minutes92.pdf, pg. 2.

[23] DMI Report, *supra* note 6 at page 14.

RESPONSES TO QUESTIONS

1) Definition of "affiliated entity"

The Instrument defines "affiliated entity" on the basis of "control", and sets out certain tests for "control". In the context of other rules relating to OTC derivatives, we are also considering a definition of "affiliated entity" that is based on accounting concepts of "consolidation" (a proposed version of the definition is included in Annex IV). Please provide any comments you may have on (i) the definition in the Instrument, (ii) the definition in Annex IV, and (iii) the appropriate balance between harmonization across related rules and using different definitions to more precisely target specific entities under different rules.

Answer: See our response to Question 2 in the CMIC response letter to the Registration Rule.

2) Definition of "eligible derivatives party"

Paragraphs (m), (n) and (o) provide that certain persons and companies are eligible derivatives parties if they meet certain criteria, including meeting certain financial thresholds. Are these criteria appropriate? Please explain your response.

Answer:

Harmonization with CFTC Rules

CMIC notes the inclusion of a commercial hedger category under paragraphs (n) and (q) of the definition of EDP, as well as the partial attempt to harmonize the EDP definition with the definition of "eligible contract participant" under CFTC rules by using a CAD 10 million threshold under paragraph (n) of the definition of EDP.[24] However, the threshold levels under paragraph (m), (n) and (o) of the definition of EDP are not harmonized with the thresholds for eligible contract participant. For non-individual counterparties, the definition of eligible contract participant uses total assets of USD 10 million for a non-individual counterparty, as opposed to net assets of CAD 25 million under paragraph (m) of the EDP definition. Many commercial hedgers would be penalized if their EDP status is determined based on net assets, as opposed to total assets since, for many of them, their "real" economic value is often comprised in large part of non-monetary assets.[25] For a non-individual counterparty that is a hedger, the eligible contract participant threshold is net worth of USD 1 million, as opposed to net assets of CAD 10 million under paragraph (n) of the EDP definition. CMIC is concerned that if these threshold levels are not aligned (subject to our further comments immediately below with respect to the commercial hedger category under paragraph (n)), or at least amended such that all eligible contract participants will be an EDP, many foreign derivatives dealers who only deal with eligible contract participants may determine that the additional time and resources required to identify whether a Canadian counterparty is an EDP will not be worth the benefit of trading with such counterparties. This could significantly reduce liquidity in the Canadian OTC derivatives market.

[24] As noted on page 4821 of NI 93-101.

[25] For example, many commercial hedgers own assets which are carried at cost on their balance sheet, net of applicable depreciation, as opposed to current fair market value. Accordingly, net assets based on balance sheet values do not fairly represent their "true" economic value.

Commercial Hedgers – Financial Threshold

With respect to the threshold level for the commercial hedger category in paragraph (n) of the EDP definition, even if it is harmonized with CFTC rules, it will still not be low enough to include all counterparties who are currently able to hedge their commercial obligations using OTC derivatives. In fact, based on best available data and without the benefit of a client outreach, at least one Canadian bank member of CMIC estimates that approximately 90% of their existing mid-market OTC derivatives client base will not qualify as an EDP under the current formulation. Another Canadian bank member of CMIC estimates that almost all of their mid-market FX clients will not qualify as an EDP under the current formulation of that definition. CMIC would like to stress that identifying a particular financial threshold is not a good proxy for sophistication as it relates to this hedger category. For example, a relatively new company with limited financial resources, but being run by experienced and educated personnel, does not mean that the company is not sophisticated. As well, many of these types of counterparties are special purpose vehicles, intentionally structured to minimize net assets. These types of counterparties should be considered sufficiently sophisticated to be EDPs without a specified financial threshold. For these types of counterparties, they may well no longer be able to find a dealer willing to trade with them if the decision is made by derivatives dealers to only deal with EDPs. If they are able to find a dealer willing to trade with them, it is certain that the materially increased cost of compliance for dealing with non-EDPs will be passed along to such non-EDPs. The result in either circumstance will likely be the same: a very large portion of hedgers will not be able to have the benefit of this key risk management tool.

The types of transactions which commercial hedgers enter into are foreign exchange forwards, swaps and options and in some instances, vanilla interest rate swaps (including cross-currency interest rate swaps) where the hedger is typically the fixed rate payer, as well as some vanilla commodities transactions (essentially energy and agricultural). With respect to foreign exchange forwards and options, the alternative to transacting with banks will be for current hedgers to use money service businesses instead which are not as highly rated as banks and are not subject to prudential regulation. In addition to disrupting access and significantly limiting liquidity in the Canadian OTC derivatives market, this will increase concentration risk and systemic risk. CMIC is concerned that the types of counterparties from whom the CSA is seeking to protect hedgers are the very ones with whom hedgers will need to transact if they no longer have access to OTC derivatives transactions with banks because they do not qualify as EDPs. As for interest rate swaps, the CSA will be aware from examining trade reporting data that banks are the only meaningful providers of interest rate swaps. A vast majority of parties that are currently hedging interest rate risk will no longer have access to interest rate swaps based upon the current definition of an EDP if the decision is made by derivatives dealers to only deal with EDPs. If dealers decide to deal with non-EDPs, the increased cost of compliance will result in prohibitively high transaction costs for these commercial hedgers. Therefore, the commercial hedger category of EDP should (i) not include a financial test, which is consistent with the current approach under paragraph 12 of the definition of “accredited counterparty” under the *Quebec Derivatives Act*, and paragraph 7 of the definition of “qualified party” under Blanket Order 91-501 (BC) *Over-the-Counter Derivatives* and Blanket Order 91-507 (AB) *Over-the-Counter Trades in Derivatives*.

Knowledge and Experience Requirement

With respect to the knowledge and experience requirement in clauses (m), (n) and (o) of the definition of EDP, the specific knowledge and experience of the counterparty should not be part of the EDP definition. Knowledge and experience are factors contributing to suitability which is a matter to be determined separately under section 12 of the Proposed Rules. Instead, it should be sufficient for the determination of a party’s status to be based on a “bright line” test, such as the total assets of a party or the fact that the transaction is being entered into for hedging purposes. Having a bright line financial resources test is consistent with the approach taken in other circumstances, for example, with respect to whether a party is an "accredited investor" under NI 45-106[26] and whether a party is a "permitted client" under NI 31-103. In neither of those cases is proficiency assessed and/or attested to as part of the determination as to whether the investor is an "accredited investor" or a "permitted client". In addition, we note that the definition of eligible contract participant under CFTC rules does not include a knowledge and experience test. As noted above, if the EDP definition is not harmonized with the eligible contract participant definition under CFTC rules, there could be a significant decline in liquidity in the Canadian OTC derivatives market.

We recognize that the CSA has indicated that this knowledge and experience test is consistent with the requirements that currently apply in Quebec under the Quebec Derivatives Act. However, we note that it only applies to the accredited counterparty definition under paragraph (7) and does not apply to the hedger branch of the definition under paragraph (12). The vast majority of counterparties that currently represent to their counterparties that they are an "accredited counterparty" are doing so based on paragraph (12) of that definition. We understand that the CSA is concerned that hedgers are in need of more protection and therefore a financial test of $10 million net assets has been incorporated. The experience of CMIC members is that those counterparties are not in need of additional protections, at least certainly not from large banks and broker dealers comprising CMIC's membership. The current "know your client" and suitability procedures undertaken by CMIC sell-side members already determine whether OTC derivatives counterparties are knowledgeable about the products they trade. As noted above, hedgers mainly transact in products that are very liquid (interest rate swaps and foreign exchange swaps, options and forwards), and in markets that are very deep, competitive and transparent. Pricing for these types of transactions is readily and easily available to hedgers from dealers in the market. Accordingly, CMIC recommends that the knowledge and experience requirement under paragraphs (m), (n) and (o) of the definition of eligible derivatives party be removed.

Concluding Remarks regarding EDP Definition

CMIC cannot over-emphasize the importance that all "eligible contract participants" under CFTC rules must satisfy the definition of an EDP. All the exemptions under the Proposed Rules and the Registration Rule are conditional upon the derivatives firm dealing with, or advising, EDPs. In CMIC's view, not having all eligible contract participants qualify as EDPs will significantly contribute to the material risk that foreign dealers will withdraw from the Canadian OTC derivatives market. In addition, with respect to the commercial hedger category under paragraph (n), Canadian banks will likely only wish to transact with and advise EDPs and, accordingly, if CMIC's recommendations are not accepted, there may be a significant number of counterparties who are currently able to hedge their risks with banks who will not be able to continue doing so if the Proposed Rules and the Registration Rule were to come into effect. Accordingly, CMIC urges the CSA to (i) harmonize the EDP thresholds under paragraphs (m) and (o) with the eligible contract participant thresholds under CFTC Rules, (ii) remove the financial threshold test for commercial hedgers under paragraph (n) and (iii) as discussed on page 19 of this letter, remove the waiver requirement for commercial hedgers under section 7(2) of the Proposed Rules. Implementing CMIC's recommendation is critical to the continued proper functioning of the Canadian OTC derivatives market.

3) <u>Anonymous transactions executed on a derivatives trading facility</u>

We are considering whether the exemption in section 41 should be expanded in respect of other requirements in this Instrument. Is it appropriate to expand this exemption?

[26] National Instrument 45-106 *Prospectus Exemptions* ("**NI 45-106**"), available at: https://www.bcsc.bc.ca/Securities_Law/Policies/Policy4/PDF/45-106__NI___October_29__2016/.

We are also considering whether a similar exemption should be available in other scenarios, including, for example:

(a) derivatives traded anonymously on a derivatives trading facility that are not cleared; and

(b) derivatives that are not traded on a derivatives trading facility but are submitted for clearing to a regulated clearing agency.

Is it appropriate to provide a similar exemption in other scenarios? Please explain your response.

Answer:

CMIC fully supports expanding this exemption under section 41 to transactions other than those traded on a derivatives trading facility ("**DTF**") that are cleared. Specifically, it is CMIC's view that this exemption should apply to any transaction entered into with a counterparty where the counterparty's identity is unknown ("**Unknown Counterparties**"), whether or not that transaction is cleared and whether or not the transaction is entered into on a DTF. For example, this may arise with block trades, where an adviser transacts on behalf of managed accounts but the dealer does not know which of the adviser's accounts will be allocated to the trade.

Further, the exemption under section 41, as currently drafted, provides that it is only available if, at the time of the transaction, the derivatives party to the transaction that is being submitted for clearing is an EDP. For transactions with Unknown Counterparties, since the derivatives dealer does not know the identity of its counterparty, it will not be able to determine whether the derivatives party is an EDP. Even though section 41, as currently drafted, only applies to transactions on a DTF, and it is likely that DTFs will only accept counterparties that qualify as an EDP, the onus should not be on the derivatives dealer to vet and ensure that is the case.

In addition, section 41 only covers an exemption from the requirements under section 10 (Know your derivatives party) and section 27 (Content and delivery of transaction information). CMIC recommends that this exemption be expanded to also cover the following sections: section 9 (Conflicts of interest), section 11 (Derivatives-party-specific needs and objectives), section 12 (Suitability), section 18 (Relationship disclosure information) and section 19 (Pre-transaction disclosure). As with the determination of whether the derivatives party is an EDP, because the identity of the counterparty is not known, the derivatives dealer is unable to make a determination and comply with those sections of the Proposed Rules. Further, whenever a derivatives dealer is transacting with an Unknown Counterparty, it is doing so through an agent and the agent should be responsible for complying with these sections since it has the relationship with the Unknown Counterparty.

4) Handling complaints

The obligations in section 16, as proposed, do not apply if a derivatives firm is dealing with (i) an eligible derivatives party that is not an individual or a specified commercial hedger, or (ii) an eligible derivatives party who is an individual or a specified commercial hedger that has waived these protections. Should the obligations in section 16 be expanded towards all derivatives parties? Please explain your response.

Answer:

The obligations under section 16 should not be expanded to all derivatives parties. In fact, it is CMIC's view that derivatives firms will be incentivized to manage (and indeed, do manage) complaints from all derivatives parties in an appropriate manner in order to preserve their relationships with such derivatives parties. It is likely that transactions with EDPs will be more frequent, and for larger amounts, further incentivizing derivatives firms to promptly respond to complaints. Adding yet another obligation under these rules for which derivatives firms need to build formal compliance procedures only adds a further unnecessary administrative burden to complying with these rules.

5) Derivatives Party Assets

We note that the requirements with respect to initial margin in sections 25 and 26 only apply to transactions with non-EDPs. Please provide any comments you may have, including whether it would be appropriate to include, for all derivatives parties, restrictions with respect to collateral delivered to a derivatives firm (as initial margin) or adopt a model of requiring informed consent with respect to its use and investment, or some combination of the two approaches.

Answer:

Derivatives Party Assets

The requirements under sections 25 and 26 of the Proposed Rules do not conform to current market practice and will be disruptive if implemented as currently drafted. Counterparties always have the right to request that initial margin be segregated, that is, physically held in a separate account, including in an account at a third party permitted depository. Such segregation comes at a cost and accordingly, the counterparty will be charged an additional fee or a higher spread for such an arrangement. Counterparties should have the right to decide whether or not they would like initial margin to be segregated and the conditions, if any, with respect to such segregation. We note that even the CFTC does not require that initial margin delivered by all counterparties be segregated, only those subject to specific margin rules for uncleared derivatives. In fact, Dodd-Frank initially required that swap dealers provide counterparties with the right to elect segregation and required swap dealers to provide a re-notification of this right to elect segregation annually, and obtain confirmation from the counterparty of both its receipt of the notification and its decision whether to elect segregation. However, the latest rules provide that counterparties be given this option only at the outset of a trading relationship.[27] While this additional administrative burden may be acceptable for the U.S. derivatives market, in CMIC's view, it will not be for the Canadian OTC derivatives market. Instead, sections 25 and 26 of the Proposed Rules should be amended to provide that only if requested by a counterparty, the derivatives firm would be required to segregate initial margin and invest initial margin as stipulated by the counterparty. There should not be a positive obligation on the derivatives firm to ask its counterparties about segregation of any margin delivered to the derivatives firm.

6) Policies, procedures and controls

Subparagraph 30(1)(c)(iii) requires a derivatives firm to have policies, procedures and controls that are sufficient to assure that an individual who transacts or advises on derivatives for a derivatives firm, conducts themselves with integrity. Please provide any comments you may have relating to this requirement, specifically about any issues relating to the implementation of the requirement in its current form. We will consider these comments in assessing the impact of this requirement on derivatives firms.

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[27] Segregation of Assets Held as Collateral in Uncleared Swap Transactions, 83 Fed. Reg. 36484 (July 30, 2018). Available here.

Answer:

Naturally, CMIC believes that everyone should conduct business with integrity, however, it is inappropriate to include such a requirement under Section 30(1)(c)(iii) in this rule for three reasons: (i) first, it would be extremely difficult to design compliance procedures around this requirement; (ii) the CSA have already incorporated a requirement for derivatives firms, and individuals acting on behalf of derivatives firms, to act honestly and in good faith which, in CMIC's view, is a more objective and manageable standard; and (iii) similar to the reasons set out with respect to the applicability of complaint handling requirements for EDPs, individuals and derivatives firms are already incentivized to act with integrity in order to attract and maintain business and client relationships. Accordingly, it is CMIC's recommendation that the requirement set out in section 30(1)(c)(iii) be deleted as it is completely unnecessary and the scope and content of any such requirement is exceedingly uncertain.

ADDITIONAL COMMENTS

Information Given to Regulator

CMIC is very concerned that there are various rules under NI 93-101 which require a derivatives firm to provide information to a provincial regulator, or provide the provincial regulator with access to information relating to a derivatives firm. For example, Section 32 provides that the derivatives firm is required to report on a timely basis to the provincial regulator where the derivatives firm is not, or was not, in compliance with NI 93-101 or securities laws related to trading or advising derivatives. In addition, Section 40(b) requires a FRFI to notify the regulator of each instance of material non-compliance with a requirement or guidance to which it is subject. Information provided to the CSA by a FRFI under these sections could well include prescribed supervisory information (PSI) depending on the specific circumstances. For example, some of these record keeping provisions relate to the prudential aspect of record keeping (e.g. business and strategic planning; audit, compliance and risk management; minutes of meetings of Boards of Directors). The reason for the concern is that PSI is protected under federal law and FRFIs are prohibited from sharing such information with anyone, including provincial regulators. It would be an offence under federal law for a FRFI to do so.[28] FRFIs can only provide this information to OSFI and it is OSFI's decision as to what information may be shared with provincial regulators. This strict federal prohibition on disclosure of PSI is a long standing feature of federal law that is designed to allow federal prudential and systemic regulators to mitigate and manage systemic risk. Accordingly, NI 93-101 should be amended to expressly exclude FRFIs being obliged to disclose PSI to provincial regulators.

Fair Terms and Pricing:

CMIC supports the change to the Companion Policy to provide that the fair dealing obligation in section 8 will be interpreted in a similar manner to mean "fair and balanced communications", consistent with CFTC Rules under Dodd-Frank.[29] However, in CMIC's view, this standard should apply not only when derivatives firms are dealing with eligible derivatives parties, but when dealing with all parties.

With respect to the fair terms and pricing obligation as set out in section 19 of the Initial Draft of NI 93-101, we note that this has now been incorporated as part of the fair dealing obligation under section 8, as described in the Companion Policy. This means that this obligation will now apply to both EDPs and non-EDPs. This is problematic for the following reasons. As noted in our Initial Response, the introduction of an express statutory duty to transact under terms that are "fair" could give rise to

[28] Supervisory Information (Banks) Regulations, SOR-2001-59 under *Bank Act* (Canada). There are equivalent regulations under federal legislation applicable to other types of FRFIs.

[29] See 17 CFR Part 23, s. 23.433.

negative unintended consequences. The derivatives dealer/counterparty relationship is not a fiduciary relationship in the ordinary course and imposing a duty to provide a "fair" price will have the unintended consequence of opening the door to significant unnecessary litigation where, in hindsight, the outcome of the trade was not as the counterparty had hoped it would be.

Certainly, as it relates to EDPs, there should not be an obligation to transact under "fair" terms. EDPs are sophisticated parties and accordingly, they should know what is fair. In fact, as we noted in our Initial Response, the end-user counterparty is actually, usually, in the best position to determine the best price for a transaction since it has the ability to solicit quotes from a number of derivatives dealers.

The Companion Policy provides that it is expected that the derivatives firm provide a derivatives party with information about the implications of terminating a derivative prior to maturity, including potential exit costs. Further, it also provides that deliberately "selling" a derivative that is not suitable for a derivatives party would not be considered "fair" and a breach of the fair dealing obligation. These statements should only apply when facing non-EDPs and the Companion Policy should be amended to clarify that.

In addition, the Companion Policy provides the following:

> As part of the policies and procedures required under section 30, a derivatives firm is expected to be able to demonstrate that it has established and follows policies and procedures that are reasonably designed to achieve fair terms, in the context, for the derivatives firm's derivatives parties and that these policies and procedures are reviewed regularly and amended as required.
>
> We interpret the fair dealing obligation to include determining prices for derivatives transacted with derivatives parties in a fair and equitable manner. We expect there to be a rational basis for a discrepancy in price where essentially the same derivative is transacted with different derivatives parties. Factors that indicate a rational basis could include the level of counterparty risk of a derivatives party, the derivatives party's trading activity, or relationship pricing. Lack of sophistication, knowledge or understanding about a derivatives product should never be a factor in providing less advantageous pricing. Both the compensation component and the market value or price component of the derivative are relevant in determining whether the price for a derivatives party is fair. A derivatives firm's policies and procedures under section 30 must address how both the price of the derivative as well as the reasonableness of compensation are determined. A derivatives party should be given an opportunity, at their option, to obtain independent advice before transacting in a derivative.
>
> Derivatives firms are expected to obtain information from each derivatives party to allow them to meet their fair dealing obligation.[30]

The pricing of a derivatives transaction depends upon a number of factors that are interrelated and therefore, it will be very difficult to establish tests to ensure a firm is in compliance with such requirement to ensure there is a "rational basis" for a discrepancy in price where a similar derivative is transacted with different derivatives parties. In terms of what it means for a transaction to be "fair", these are privately negotiated, bilateral, unique transactions. There is no simple way to determine whether all the components of a trade are fair. Therefore, there is no "fair" price in the traditional meaning of the term. The "fair" price will be whatever is agreed upon between the two parties, bearing in mind the competitive nature of the industry. Simply stated, if the derivatives party does not

[30] See page 4872 and 4873 of NI 93-101.

like the price quoted by a derivatives dealer, it is free to ask other dealers in the market for a competitive quote. Even then, variations in prices quoted by different dealers could simply be a result of a dealer's internal costs, including liquidity costs, capital charges and related hedging costs, producing higher or lower pricing and may be affected by market volatility. In this context, it would not be the case that an "unfair" price is being quoted. Finally, it is very uncertain what type of information is necessary to be obtained before a party can meet a "fair" dealing obligation.

CMIC therefore strongly recommends that the fair pricing commentary be removed from the Proposed Rules completely. Given the nature of derivatives transactions, the term "fair" in the context of "fair price" should be interpreted to mean what is commercially reasonable.

Waiver by Specified Commercial Hedgers

With respect to specified commercial hedgers, CMIC notes that Section 7(2) of the Proposed Rules requires that a waiver must be obtained by a derivatives firm from a specified commercial hedger if such derivatives firm wishes to be exempt from the provisions of the Proposed Rules, other than those set out in Section 7(1)(a)-(d) as they relate to such specified commercial hedger. There is no policy reason provided as to why specified commercial hedgers would need to provide such a waiver. Such a waiver is not necessary given that specified commercial hedgers are sophisticated entities. Further, the administrative burden of obtaining waivers from these clients will be significant. As noted in our discussion of the definition of EDP on page 12, CMIC strongly believes that derivatives firms will only wish to deal with EDPs in order to rely on the exemption under Section 7(1) of the Proposed Rules. Accordingly, if a waiver is not obtained from a specified commercial hedger, their access to the OTC derivatives market will effectively be eliminated, even though they meet the definition of an "EDP". In addition, no other current derivatives rule in Canada dealing with the exemption of protections under securities or derivatives legislation requires such a waiver.[31] CMIC therefore urges the CSA to remove this waiver requirement and treat specified commercial hedgers the same as all other EDPs.

Senior Derivatives Manager Regime

As noted in our Initial Response, compliance is a top priority for CMIC members, including ensuring that the right persons within the organization are monitoring and enforcing compliance matters and that responsibility for compliance matters is properly and clearly allocated. However, it is still not clear to CMIC (i) why the proposed senior derivatives manager regime is considered necessary in Canada, (ii) why the OTC derivatives market is being singled out since it is our understanding that a similar regime does not exist for the securities market, or indeed, any other market in Canada, and (iii) why existing compliance regimes are not satisfactory. No reason for introducing this unique regime in Canada has been identified. No explanation for why existing, regulation is insufficient has been provided. It is increasingly difficult to find people to fill current compliance roles due to the additional risk and responsibilities associated with such roles. It will become even harder to staff these senior manager roles from the ever decreasing pool of talent. In CMIC's view, it would appear that the cost, (including the time and effort required to maintain such a regime, not to mention its negative effect on liquidity/access given the unique nature of this regime), is not worth any as yet unidentified benefits to be derived from implementation. Accordingly, CMIC continues to recommend removing this regime from the Proposed Rules.

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[31] For example, see: (i) the "qualified party" definition in British Columbia under Blanket Order 91-501 *Over-the-Counter Derivatives*, available at: https://www.bcsc.bc.ca/Securities_Law/Policies/Policy9/PDF/91-501__BCI_/; (ii) the "qualified party" definition in Alberta under Blanket Order 91-506 *Over-the-Counter Trades in Derivatives*, available at: http://www.albertasecurities.com/Regulatory%20Instruments/4980944%20_%20Blanket_Order_91-506_Over-the-Counter_Trades_in_Derivatives.pdf; and (iii) the "accredited counterparty" definition in Quebec under the Quebec Derivatives Act.

If the CSA is unwilling to remove the senior derivatives manager regime, that regime should apply only to a derivatives business unit of a derivatives firm that deals with, or advises, non-EDPs. Otherwise, CMIC is very concerned that including this senior derivatives manager regime as currently proposed will lead to a significant reduction of liquidity/access in the Canadian derivatives market given that the requirements go beyond the OTC derivatives requirements in other jurisdictions, for example, the requirement to report directly to state or local securities regulators.

While CMIC is concerned that other regulatory regimes will not have a similar senior derivatives manager regime, we have reviewed legislation applicable to CMIC's sell-side members and have determined that, on an outcomes basis, substituted compliance should be given to Canadian financial institutions and to foreign dealers registered as CFTC swap dealers. Our Initial Response outlined in great detail the current, robust, existing compliance regime applicable to Canadian financial institutions, which represents a comprehensive approach to compliance and accountability that is consistent with existing global financial institution regulation. In fact, Canadian financial institutions are internationally well regarded in this area.

With respect to foreign dealers registered as "swap dealers" under CFTC rules, substituted compliance should be given to them on an outcomes basis. The supervisory requirements under the CFTC rules[32] provide as follows:

> CFR Title 17 Section 23.602(a): Each swap dealer and major swap participant shall establish and maintain a system to supervise, and shall diligently supervise, all activities relating to its business performed by its partners, members, officers, employees, and agents (or persons occupying a similar status or performing a similar function). Such system shall be reasonably designed to achieve compliance with the requirements of the Commodity Exchange Act and Commission regulations.

Swap dealers under CFTC rules that are prudentially regulated may likely be required to comply with similar rules and accordingly substituted compliance would apply to them.

CMIC notes that the Companion Policy provides that, other than in a small derivatives firm, the CSA would not expect a senior derivatives manager to be the chief executive officer of the derivatives firm, or an individual registered under NI 93-102 (if applicable) as any of the derivatives ultimate designated person, derivatives chief compliance officer or derivatives chief risk officer of the derivatives firm. It is not clear why this could not be the case. It should be acceptable and appropriate for a derivatives firm to make its own assessment as to who should be a senior derivatives manager.

Suitability:

CMIC believes very strongly that it is inappropriate to impose fiduciary or fairness standards on the OTC derivatives market, and doing so will significantly reduce liquidity in the Canadian market. The OTC derivatives market is different than the securities market in that the derivatives dealer is acting in the capacity of a counterparty to a transaction, and not as a fiduciary, and accordingly, should not be required to assess the suitability of any transaction or trading strategy involving a derivative for its counterparty. Derivatives dealers routinely operate based on a standard of commercial reasonableness, and not an equitable fairness standard. If the Canadian business conduct rules impose this type of fairness standard, it is CMIC's view that U.S. and other foreign dealers would be unwilling to risk the potential legal consequences of participating in this market, resulting in decreased liquidity and customer access. CMIC notes that under the CFTC rules, a swap dealer will be deemed

[32] CFR Title 17 Section 23.602(a).

to satisfy its suitability obligations if, among other things, (i) it determines that the counterparty (or an agent to which the counterparty has delegated decision-making authority) is capable of independently evaluating risks with regard to the relevant swap or trading strategy involving a swap, and (ii) the counterparty (or its agent) represents in writing that it is exercising independent judgment in evaluating the recommendations of the swap dealer.[33] A similar safe harbour should be included under the Proposed Rules and such a safe harbour is imperative in order to maintain liquidity in the Canadian OTC derivatives market.

In addition, CMIC believes that the scope of the suitability obligations in respect of individuals as contemplated under Section 12 is too wide, particularly insofar as these obligations appear to require any individual acting on behalf of a derivatives firm to take reasonable steps to assess suitability. In CMIC's view, if an individual acting on behalf of a derivatives firm is to have this obligation, only the trader should be responsible for assessing suitability. It would be unreasonable to impose such a suitability obligation on everyone in the derivatives firm who "touches" the transaction, for example, a back office person or in-house counsel. We note that under NI 31-103,[34] only registrants are required to assess suitability and, accordingly, a similar approach should be taken with respect to OTC derivatives.

Reporting to Derivatives Parties

With respect to the requirement for derivatives dealers to provide daily valuations, the Proposed Rules should allow counterparties to be given the option of not being provided with the daily valuation required under section 20(1) as certain counterparties may not be interested in receiving that information. In such circumstances, the derivatives firm should not be required to make that information available to those counterparties.

Record-keeping

It is current market practice for FX transactions to be entered into between parties without entering into a written ISDA (or similar) master agreement due to the fact that the FX markets are mature and transparent. CMIC notes that, notwithstanding this market practice, both the CFTC rules and section 33 of NI 93-101 require that parties enter into a written agreement before transacting in a derivative. In order to continue with market practice, under CFTC rules, swap dealers may satisfy the written agreement requirement in respect of certain FX transactions by way of a deemed ISDA pursuant to the ISDA Dodd-Frank protocol. CMIC notes that it is unlikely that derivatives firms in Canada will be able to enter into a comparable protocol providing for deemed ISDAs, in light of the small size of the Canadian derivatives market and the resulting difficulty of obtaining responses to a client outreach. As a result, derivatives firms may be required to enter into written agreements when engaging in FX transactions in Canada, but may not be required to enter into such agreements when engaging in FX transactions in the U.S. In order to avoid this regulatory inconsistency and the disruption it would cause, CMIC believes that it would be appropriate for the CSA to include an exemption from the written agreement requirement for FX transactions, which would align with current market practice. As noted above, FX markets are mature and transparent, and because foreign exchange products are frequently used as hedging products, it may be less important for derivatives firms and derivatives parties to enter into written agreements in connection with such transactions.

[33] See 17 CFR Part 23, s. 23.434(b).

[34] National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**").

Tied Selling

CMIC reiterates that the tied selling rules are duplicative of existing rules found in Canadian legislation. For example, there are provisions under the Bank Act[35] which provide that a bank may not impose undue pressure on, or coerce, a person to obtain a product or service from a particular person as a condition for obtaining another product or service from the bank. Similarly, the *Unfair or Deceptive Acts or Practices Regulation* under the *Insurance Act* (Ontario) provides that no person shall engage in any unfair or deceptive act or practice, which is defined to include making the issuance or variation of a policy of automobile insurance conditional on the insured having or purchasing another insurance policy. CMIC also believes that it is inappropriate to impose a prohibition on tied selling under the Proposed Rules, which again, does not have an analogue under the CFTC rules nor under MiFID II. Accordingly, since there are existing regulations dealing with tied selling, along with the fact that there are no tied selling provisions under the CFTC rules nor MiFID II, the tied selling provisions should be deleted from the Proposed Rules.

Transition (permitted client/qualified party/accredited counterparty)

CMIC supports the inclusion of section 45(3) which allows derivatives dealers to rely on existing representations received in connection with pre-existing transactions. However, in CMIC's view, clarification is required in order to determine under what circumstances sections 20 and 28 will need to be complied with. Sections 20 and 28 are only applicable in the case of non-EDPs and individual EDPs and commercial hedgers who have not waived their protections under these two provisions. In CMIC's view, derivatives dealers should be able to assume that such waivers have been provided when relying upon the representations as set out in section 45(3)(b). This would mean that only section 8 would need to be complied with as it relates to such individual EDPs and commercial hedgers.

Effective Date

CMIC recommends that there be a transition period of at least three years, starting with the date the rules come into force. In addition, CMIC urges that the registration rule and the business conduct rule take effect concurrently. Where a client outreach initiative is required, in order to avoid regulatory fatigue, it is imperative that this be done only once. Accordingly, both rules should be finalized before the three year transition period commences. This would then give derivatives firms three years to prepare for both new business conduct requirements and for registration and all the related obligations, such as implementing appropriate policies and procedures, finding and training personnel, conducting any client outreach initiatives, obtaining representation letters and amending existing documentation where necessary.

CONCLUSION

As you will have seen, CMIC has provided its comments and recommendations on the Proposed Rules within the six themes of (i) derivatives market liquidity, (ii) incomplete rules, (iii) balanced derivatives market regulation, (iv) fundamental differences between the OTC derivatives market and the securities market (for example, Inter-dealer Exclusion, FX Transaction exemption, and fair terms and pricing recommendations), (v) harmonization with global rules, and (vi) the timing of implementation (effective date recommendation).

[35] See the Bank Act, s. 459.1.

CMIC welcomes the opportunity to discuss this response with you. The views expressed in this letter are the views of the following members of CMIC:

Alberta Investment Management Corporation
Bank of America Merrill Lynch
Bank of Montreal
Bank of Tokyo-Mitsubishi UFJ, Ltd., Canada Branch
Caisse de dépôt et placement du Québec
Canada Pension Plan Investment Board
Canadian Imperial Bank of Commerce
Deutsche Bank A.G., Canada Branch
Fédération des Caisses Desjardins du Québec
Healthcare of Ontario Pension Plan Trust Fund
HSBC Bank Canada
Invesco Canada Ltd.
JPMorgan Chase Bank, N.A., Toronto Branch
Manulife Financial Corporation
Morgan Stanley
National Bank of Canada
OMERS Administration Corporation
Ontario Teachers' Pension Plan Board
Public Sector Pension Investment Board
Royal Bank of Canada
Sun Life Financial
The Bank of Nova Scotia
The Toronto-Dominion Bank